In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 1587

AMERICAN NATIONAL BANK OF AUSTIN, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The memorandum and order of the district court (Pet. App. B1–B15; R. 206–216)[1] are reported at 296 F. Supp. 512. The opinion of the court of appeals (Pet. App. A1–A24) is reported at 421 F. 2d 442.

JURISDICTION

The judgment of the court of appeals was entered on January 19, 1970 (Pet. App. A25–A26). Petitioner's petition for rehearing was denied on February 18, 1970 (Pet. App. A27). The petition for a writ of

[1] "R." references are to the record appendix filed in the court of appeals.

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certiorari was filed on May 18, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether petitioner, a national bank, was taxable on the interest it received on certain municipal bonds because, in substance, it acquired and held these bonds not as the owner thereof, but as a secured lender.

STATUTE INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

> SEC. 103. Interest on certain governmental obligations.
>
> (a) *General Rule.*—Gross income does not include interest on—
>
> (1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia;
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> * * * * *

STATEMENT

Petitioner is a national banking association located in Austin, Texas, where most bond issues floated by political subdivisions of the State of Texas are executed and delivered. Petitioner's banking house is frequently designated as the place of delivery for such issues, and petitioner performs a number of services including collection of the bid price, transmittal of payment to the issuing authority, and delivery of the bonds to the purchasing dealer. (R. 18–21.)

The issue in this case involves a continuing practice of petitioner pursuant to an unwritten understanding with area bond dealers whereby petitioner, on the request and authorization of a dealer who has

successfully bid on an issue of high grade municipal bonds, pays the bid price to the issuing authority with its own funds. Petitioner retains the bonds, in bearer form, for short periods (generally not more than thirty days) while the dealer attempts to sell the bonds to its retail customers. Petitioner does not submit bids on issues on its own behalf and is not authorized to sell bonds to the public. (R. 21–28.)

A dealer acting under this arrangement with petitioner usually offers bonds to the public for future delivery as soon as he has been awarded an issue; ordinarily he has sold a substantial portion of the issue before the bonds are acquired by petitioner, and he continues to sell the bonds after petitioner acquires them. As he finds customers, the dealer sends petitioner an invoice made out to the customer, and petitioner sends the bonds and the invoice to the bank at which the sale is to be closed. The collecting bank, upon closing the transaction, remits the purchase price to petitioner or credits it to petitioner's account. When all of the bonds in an issue have been sold, final settlement between petitioner and the dealer is effected. Petitioner receives the price it paid for the bonds plus accrued but uncollected coupon interest and handling charges. The dealer receives any excess collected from the sale of the bonds or remits any deficiency to petitioner. (R. 25–27.)

These transactions are cast in the form of purchases of the original issues by petitioner, subject to the right of the dealer to repurchase the issue at the price paid by petitioner. (R. 22). Although it does not appear that petitioner has ever had a written contract to require dealers to repurchase bonds, no dealer refused

to do so in any of the 4,500 transactions of this type during the years in question—1962, 1963, and 1964—even when the repurchase required that the dealer take a loss (R. 152, 204). Only twice in prior years did a dealer fail to take up bonds at petitioner's purchase price (R. 79–80, 103–104). Because petitioner enjoyed a position of predominance in the distribution of municipal bond issues in Texas, dealers were, as a practical matter, required to insulate petitioner from market fluctuations if they wished to continue to market new bond issues (Pet. App. A16, A22).

Petitioner accrues the interest due on the bonds from the date of acquisition to the date of disposition (R. 24, 25). It also clips the coupons as they become due and collects and keeps the coupon interest (R. 24). On its federal income tax returns during the years in question petitioner reported the interest which it received while holding these bonds as tax exempt interest under Section 103 of the Internal Revenue Code of 1954, *supra*, p. 2. The Commissioner determined that in substance the bonds belonged to the dealers, that petitioner was a secured lender, and that the interest received by petitioner represented a taxable payment to petitioner for financing the dealers' purchases. Petitioner paid the resulting deficiencies and brought this refund action. (Pet. B. 2; R. 207.) The district court held that petitioner owned the bonds outright and that the interest it received was therefore tax exempt (Pet. B. 14; R. 215–216). The court of appeals reversed on the ground that the economic substance of these transactions was as determined by the Commissioner (Pet. A. 24).

ARGUMENT

The decision below is correct. There is no present conflict or any other ground warranting review by this Court.

1. Petitioner's basic contention (Pet. 22) is that it must be considered the owner of the bonds, rather than a secured lender, because there was no binding and legally enforceable obligation on the part of the dealers to repay petitioner the funds it advanced to purchase the bonds. Petitioner chooses to ignore the overriding principle repeatedly reaffirmed by this Court, that the substance of a transaction, not the form, is determinative of the tax consequences. *Gregory* v. *Helvering*, 293 U.S. 465; *Knetsch* v. *United States*, 364 U.S. 361; *Helvering* v. *Horst*, 311 U.S. 112; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260.

Under the arrangements made by the parties here, the dealer alone determined the bid price for the bonds; it was intended and expected that the dealer would reacquire the bonds at the prices paid for them by petitioner, and, as a matter of business necessity, the dealer was required to do so; the dealer alone fixed the prices and times at which the bonds were sold to its customers; and in every one of 4,500 instances during the three years in issue, the bonds were redeemed by the dealer at full price, even when this resulted in a financial loss to the dealer. Thus, the parties intended to enter into, and in fact executed, transactions in which the dealer enjoyed and suffered all of the economic consequences of the ownership of the bonds, including the consequences of mar-

ket fluctuations, and petitioner was compensated only for the temporary use of its money. In these circumstances, the court of appeals was fully justified in concluding that in substance the transaction was a pledge, and that the dealers owned the bonds, and petitioner was a secured lender, even though the dealers' obligations to repay may not have been legally enforceable.[2]

Cases cited by petitioner (Pet. 22) regarding the necessity of an obligation to repay are not in conflict with the decision below, as asserted (*ibid.*). The issue in each of those cases was whether the taxpayer was entitled to an interest or bad debt deduction, and in none of them was the existence of the practical equivalent to a legally enforceable obligation asserted or shown.

2. Petitioner also asserts conflict (Pet. 18–21) between the decision below and that of the Sixth Circuit in *Union Planters Nat'l Bank* v. *United States*, C.A. 6, No. 19049, decided May 4, 1970 (set out in the Appendix, *infra*, pp. 11–18), on the one hand, and the earlier decisions of the Ninth and Tenth Circuits in *Commissioner* v. *Bank of California*, 80 F.2d 389 (C.A. 9), and *First National Bank in Wichita* v. *Commissioner*, 57 F.2d 7 (C.A. 10), on the other. In each of the cited cases, as in this case, the ultimate question was whether a bank was the owner of municipal bonds entitled to exclude the interest thereon under Section

[2] There was, to be sure, a remote possibility that a dealer would be unable or unwilling to repurchase the bonds, and that petitioner might therefore be required to assume the consequences of ownership. (See Pet. App. A22.) However, this possibility exists even in a classic debt situation with an unquestioned legal obligation for repayment.

103 (or its predecessors), or a secured lender. The Sixth Circuit, like the Fifth Circuit here, held that this question was one of law and reversed a district court decision favorable to the bank. The Ninth and Tenth Circuits, treating the question as one of fact, affirmed decisions of the Board of Tax Appeals favorable to the bank and the Commissioner, respectively, on the ground in each instance that there was substantial evidence to support the Board's finding.

There is no conflict with *Bank of California* as to the decision on the merits, since the Ninth Circuit held only that there was record support for the Board's decision for the bank. There is admittedly, however, a difference in approach between the Fifth and Sixth Circuits and the Ninth and Tenth Circuits in terms of the proper scope of appellate review of the ultimate question presented.

Despite this difference in approach, review by this Court is unwarranted at this time. The decisions of the Ninth and Tenth Circuits were handed down 35 and 38 years ago, respectively, and reflect a view of the relationship in tax matters between questions of law and fact which has been the subject of refinement and substantial change. The decisions of the Fifth and Sixth Circuits are examples of the current, and, we submit, more realistic view. They recognize the essential distinction between the determination of the various rights and obligations of the parties under their arrangement (questions of fact), and the determination whether this set of rights and obligations should be characterized as a sale or a loan (a ques-

tion of law).[3] Underlying the holdings of both courts is the notion that ownership is not a legal right but a legal classification used to describe a given set of rights and liabilities. We believe that if the question here presented were to arise again in the Ninth and Tenth Circuits, those courts would take the same view of the scope of appellate review that the Fifth and Sixth Circuits have taken.[4]

Nothing in *Commissioner* v. *Duberstein*, 363 U.S. 278, cited by petitioner (Pet. 23), is inconsistent with this conclusion. The Court there held that the question whether a financial benefit received by a taxpayer is a gift or taxable compensation depends entirely on the subjective motives of the donor, and that the findings of the trial court with respect to this purely factual question are subject to review on appeal under the clearly erroneous rule. In this case, unlike *Duberstein*, the parties' intentions are not in dispute and are not, as a matter of substantive law, determinative of the tax consequences.

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[3] Petitioner's contention (Pet. 23) that the court of appeals disregarded the clearly erroneous rule, Rule 52(a) of the Federal Rules of Civil Procedure, assumes that the question whether petitioner was the owner of the bonds, or a secured lender, is a question of fact. This is the very point in issue.

[4] This is strongly suggested in the case of the Ninth Circuit—the only circuit in which a bank has been found to be an owner of bonds in similar circumstances—by three recent decisions of that court. *Lundgren* v. *Freeman*, 307 F. 2d 104, 115; *Fleischmann Distilling Corp.* v. *Maier Brewing Co.*, 314 F. 2d 149, 152; *Kippen* v. *American Automatic Typewriter Co.*, 324 F. 2d 742, 745. We know of no recent decision of the Tenth Circuit that speaks to the point.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.
JOHNNIE M. WALTERS,
Assistant Attorney General.
WILLIAM A. FRIEDLANDER,
GARY R. ALLEN,
Attorneys.

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APPENDIX

United States Court of Appeals for the Sixth Circuit

No. 19409

UNION PLANTERS NATIONAL BANK OF MEMPHIS,
PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF TENNESSEE, W.D.

Decided and Filed May 4, 1970

Before CELEBREZZE, MCCREE, and COMBS, Circuit Judges.

MCCREE, Circuit Judge. This appeal presents the question whether coupon interest collected by a bank as owner of municipal bonds subject to repurchase agreements is exempt from taxation under § 103(a) of the Internal Revenue Code. We hold that under the circumstances of this case, it is not and accordingly we reverse the decision of the District Court, 295 F. Supp. 1151 (W.D. Tenn. 1968). Since 1938 or 1939, appellant Bank has purchased municipal bonds [1] from local bond dealers, subject to agreements permitting the Bank to require repurchase by the dealer at any

[1] The term "municipal bonds" is used in this opinion to include those bonds and obligations issued by states, municipalities, and other local governmental units, which qualify for the exemption granted by § 103(a).

time at the price paid by the Bank. The evidence does not disclose an instance when the Bank invoked this provision. Rather, as the District Judge found, "it was the intent and practice that the bonds be reacquired by the dealer upon the dealer's request . . . ." 295 F. Supp. at 1152. The dealer usually repurchased the bonds when he had found a customer for them. The Bank invariably resold to the dealer at the same price it had paid him (this price was either the dealer's cost or a lower figure), and the dealer's repurchase at this price protected the Bank from experiencing any loss on the transaction.

During the period in which the Bank held the bonds, it would clip bond coupons as they matured and collect and retain the interest. On repurchase by a dealer, the Bank would be credited with the pro rata interest accruing from the last coupon redemption date until the date of repurchase. The tax treatment of coupon interest realized by the Bank in this manner in the years 1961–64 is the subject of this appeal.

The Bank claims that since it was the owner of the bonds and the coupons, the interest income from them should be exempt from taxation under § 103(a). The Government, on the other hand, insists that each transaction between the Bank and the dealers was in reality a loan secured by what was in effect a pledge of the bonds. Thus, the coupon interest belonged to the dealers and, when they permitted the Bank to keep it, they were paying the Bank what was in effect ordinary interest on the loan, which is income not

exempt from taxation under § 103(a). Viewed in this context, the Government argues, the transactions constitute an attempt to avoid the effect of § 265(2) of the Internal Revenue Code. This provision disallows deductions of interest paid on loans the proceeds of which are used to buy municipal bonds. Its obvious purpose is to deny the recipient of tax exempt income the further tax benefit of deducting the cost of money employed to purchase the securities which produce it. Accordingly; if the dealer had borrowed the money to purchase the bonds, the coupon interest would be tax-free to him, but he would not be able to deduct the interest paid to the Bank for the loan; and the Bank, of course, would be taxed fully on the income represented by that interest. But if the transactions are characterized as sales-repurchases, the Government contends, the Bank will avoid paying tax on the coupon interest, which in economic effect is equivalent to interest paid for the use of its money, and the dealer will have obtained the funds to purchase the bonds without paying interest. Thus, if the parties' characterization of these transactions is accepted as decisive for federal income tax purposes, they would be able to enjoy the benefit of the double tax advantage which Congress intended to prevent.

The form of these transactions tends to support the Bank's arguments. And the Government does not dispute the fact that the Bank held title to the bonds in a property law sense. Moreover, the Bank did not list these transactions on its books as "loans" except

when required to do so by the Comptroller of the Currency from 1957 to 1964.[2]

However, other facts found by the District Court support the Government's position. The bond dealers would list these bonds for sale in trade publications in the same manner as bonds to which they held legal title. When a dealer found a customer for the bonds, he would repurchase them from the Bank which never refused to resell although, under the written repurchase agreements, it was not bound to do so. The District Judge found that it was understood between the parties that the Bank would always consent to such repurchases. Most important, the Bank was protected under the repurchase agreements from suffering any loss, and its gain was limited to the amount of coupon interest accruing during the time it held the bonds.[3] In some cases, when the market price of the bonds was falling, the Bank required the dealer to pay, in advance of repurchase, money sufficient to protect it in the declining market. Obviously this practice served

[2] Although not listed as loans during 1938–57 and 1964–70, nevertheless they were not carried on the Bank's books in the same category as bonds purchased for investment, which were of course not subject to the kind of repurchase agreements we are concerned with here.

[3] On three occasions when the dealer refused to repurchase on demand by the Bank, the Bank sold the bonds to a third party and kept the resulting profit. The record does not disclose the details of these transactions, except that in one case the dealer was "probably insolvent". We would assume that all three dealers in question were insolvent or defunct; otherwise why would they refuse to repurchase when a profit was apparently guaranteed? In any event, these isolated incidents do not alter our opinion about the substance of the many dozens of these transactions.

the same purpose as the requirement of the posting of additional margin by a borrower whose security is decreasing in value. It is clearly more consistent with the characterization of these transactions as loans than as sales.

The District Court, in ruling for the Bank, held that "[t]he determination of this case requires an inquiry into the intent of the parties." 295 F. Supp. at 1152. We do not agree that subjective intent is decisive here. The intent of the parties may be important in determining just what their contractual relations *inter sese* were, but there is little dispute here about what obligations and rights the parties expected their agreement to confer. This case hinges, rather on the legal characterization, for federal income tax purposes, of the transactions between the parties. That characterization is not a question of fact, but rather one of law. *Cf. Cordovan Associates, Inc.* v. *Dayton Rubber Co.*, 290 F. 2d 858 (6th Cir. 1961). Accordingly, we are not bound by the District Court's conclusion that the Bank should be treated as the owner of the bonds for federal income tax purposes.[4]

[4] The intent which the District Court found binding was apparently the bank's intent to adopt the form of sale and repurchase, rather than that of a secured loan. It should come as no surprise that taxpayer wished to characterize the transactions in this way, because it results in minimum tax liability, and does not give any of the parties any economic rights which they would not have had if the transactions had been characterized as loans. If this kind of intent is to be decisive, then, as the Government argues, any taxpayer could "determine its own tax liability by choosing the names which its arrangement should be called when those labels will affect nothing but its tax liability." *Cf. Burnet* v. *Harmel*, 287 U.S. 103, 110 (1932).

We are not here concerned with an area of law where intent determines whether or not an increment of wealth is to be deemed income, as was the case in *Commissioner* v. *Duberstein*, 363 U.S. 278 (1960), where the presence or absence of a subjective state of mind, donative intent, was declared to be decisive. Here the question is not whether or not an increment of wealth is income (for it clearly is), but whether it is income from interest paid by a borrower, or tax exempt interest income from municipal bonds.

In cases where the legal characterization of economic facts is decisive, the principle is well established that the tax consequences should be determined by the economic substance of the transaction, not the labels put on it for property law (or tax avoidance) purposes. *E.g.*, *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 266–67 (1958); *Gregory* v. *Helvering*, 293 U.S. 465 (1935). "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." *Helvering* v. *Lazarus & Co.*, 308 U.S. 252, 255 (1939).

Here it is clear that the coupon interest functioned as the interest collected on a loan, however the parties may have characterized the transactions on their books. Like any secured lender, the Bank took great paths to insure itself against any loss of principal, even to the extent of requiring margin payments (which took the paper form of advances on the repurchasing price). And like any borrower on security, the dealer was obliged to pay only the amount of the principal in order to extinguish his

obligation, besides having to forego the gains he would otherwise have made through the maturing of interest coupons. In contrast, in a transaction that would be characterized as a sale for tax purposes, we would expect the Bank, rather than the dealer, to assume the risk of fluctuations in the market value of the bonds.

The Fifth Circuit has recently ruled for the Government in a substantially identical case. *American National Bank of Austin* v. *United States*, No. 27301 (Jan. 19, 1970). We think that the Government's case here is, on balance, stronger than in the *Bank of Austin* case. Here, there were written repurchase agreements under which the Bank could oblige the dealer to repurchase at any time at a price which would guarantee the Bank against any loss; in *Austin*, the dealers had only an unwritten option to repurchase, and there was no written contract as there was here. Other differences between the operations of the Austin and Memphis banks[5] we deem immaterial.

We hold, for the reasons found persuasive by the Fifth Circuit in Judge Ainsworth's opinion, that these transactions, although characterized as sales-repurchases by the parties, will be regarded as secured loans for federal income tax purposes, and that accordingly, the Bank, as economic lender, cannot

[5] Apparently the Austin bank usually conveyed bonds directly to customers of the dealers. The Memphis bank, with a few exceptions, consistently observed the formalities of sale and repurchase. Of course such adherence is not dispositive in tax cases when the real question is the economic substance of the transaction.

exclude the bond interest from its taxable income. The judgment of the District Court is reversed, and the case is remanded for entry of judgment and other proceedings not inconsistent with this opinion.

U.S. GOVERNMENT PRINTING OFFICE: 1970